



Director of
Central
Intelligence

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CIA HISTORICAL REVIEW PROGRAM
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1999

Gorbachev's Economic
Programs: The
Challenges Ahead

National Intelligence Estimate

*This National Intelligence Estimate represents
the views of the Director of Central Intelligence
with the advice and assistance of the
US Intelligence Community.*

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NIE 11-23-88
December 1988

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Gorbachev's Economic Programs: The Challenges Ahead

Information available as of 20 December 1988 was used in the preparation of this National Intelligence Estimate.

The following intelligence organizations participated in the preparation of this Estimate:

The Central Intelligence Agency
The Defense Intelligence Agency
The National Security Agency
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also participating:

The Office of the Deputy Chief of Staff
for Intelligence, Department of the Army
The Office of the Director of Naval
Intelligence, Department of the Navy
The Office of the Assistant Chief of Staff,
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The Office of the Deputy Assistant Secretary for
Intelligence, Department of Energy
The Director of Intelligence, Headquarters, Marine Corps

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Key Judgments

We believe that Gorbachev's efforts at reviving the Soviet economy will produce no substantial improvement over the next five years, although his efforts to raise consumer welfare could achieve some modest results. Soviet attempts to raise technology levels will not narrow the gap with the West in most sectors during the remainder of this century.¹

Gorbachev's economic program has so far failed consumers, who, according to anecdotal evidence, probably feel somewhat worse off now than they did when Gorbachev assumed power in 1985. To improve consumer welfare, Gorbachev has begun to place more emphasis on housing, food processing, and light industry; and the defense industry is being told to increase its production for consumers. Gorbachev has also sought to expand the private and cooperative sectors through long-term leasing arrangements in both agriculture and industry. These initiatives are the ones that are most likely to improve the quality of life in the Soviet Union over the next five years.

Gorbachev's effort to reform the country's system of planning and management and to improve the country's capital stock is going poorly. Ill-defined reform legislation, interference by ministries, and piecemeal implementation are creating disruptions and preventing progress. Reforms already planned in the state sector will probably be implemented slowly. Sharp moves toward a market economy would be very disruptive and would jeopardize popular support for his programs. Nevertheless, Gorbachev has often dealt with setbacks by adopting radical measures, and we cannot rule out an effort to move rapidly toward a market economy in the state sector.

To promote growth of private enterprise, Moscow must allow more flexibility and reliance on the market for leasing and cooperative arrangements in order to increase significantly the production of goods and services for consumers. A resentful public and skeptical bureaucracy will make this difficult. Lease contracting in agriculture will remain bound by centrally directed procurement targets, reliance on state supplies, and a

¹ *The Director, Defense Intelligence Agency, believes that this uneven performance could include sufficient improvement in the Soviets' economic and technical base to facilitate fulfillment of future military requirements. Moreover, since the Soviets already lead in several key defense technologies, they should be able to continue assimilating technology gains in this sector.*

recalcitrant bureaucracy. The comparatively high prices of privately supplied goods will spur inflation. An added problem for Moscow is that these reforms probably will be most successful, at least initially, in non-Russian areas such as the Baltic states and the Caucasus.

We do not foresee a large, sustained increase in Soviet imports from the West. The Soviets may increase borrowing to perhaps \$3-4 billion net per year over the next few years. Even a much larger surge in borrowing from the West, which we think is unlikely, would not aid the overall economy substantially or ameliorate the resource competition between the military and civilian sectors. A few industries may benefit, however.

We judge Gorbachev will divert additional resources from defense—including managers, equipment designers, investment funds, and plant capacity—to his civilian programs. While we recognize there is some redundant defense plant capacity, significant increases in the production of goods for the civilian sector would require a diversion of resources from the military. Diversion from defense to civilian objectives will escalate conflicts over resource allocation because it could delay upgrades to weapons plants, thereby postponing the introduction of new systems. Clearly there are strong economic pressures for major reductions in military spending. Striking the right balance will involve many leadership arguments and decisions over the entire period of this Estimate. In any case, the large-scale modernization of Soviet defense industries in the 1970s has already put in place most of the equipment needed to produce weapon systems scheduled for deployment through the early 1990s.²

Moscow will press harder on Eastern Europe for more and higher quality machinery and consumer goods, for greater participation in joint projects, and for greater contributions to Warsaw Pact defense. Such demands will produce only marginal benefits for the USSR because of real economic constraints in Eastern Europe and the reluctance of its regimes to increase their help to the Soviets.

There is some chance that Gorbachev's economic programs may not survive. Disruptions, such as widespread reform-related work stoppages or a drastic drop in performance indicators, might strengthen conservative opposition. Such trends, coupled with continuing nationality turmoil, could force the leadership into a major retreat.

² The Director, Defense Intelligence Agency, holds an alternative view that a critical distinction must be made between near-term resource allocation trade-offs that can be made without significantly disrupting current defense procurement, and those of the longer term where a downward turn in defense spending trends may result in reordering or stretching out of weapons procurement.

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Given the severity of Soviet economic problems, Gorbachev needs the many benefits of a nonconfrontational international environment. This gives the United States and its allies considerable leverage in bargaining with the Soviets over the terms of that environment on some security issues such as regional conflicts and arms control and on some internal matters such as human rights and information exchange. The margins of this leverage will be set by Moscow's determination not to let the West affect the fundamental nature of the Soviet system or its superpower status.³

³ For a fuller discussion of these issues, see SNIE 11-16-88, *Soviet Policy During the Next Phase of Arms Control in Europe*, November 1988; NIE 11-3/8-88, *Soviet Forces and Capabilities for Strategic Nuclear Conflict Through the Late 1990s (Volume I)*, December 1988; and the forthcoming Estimates NIE 11-14-88, *Trends and Developments in Warsaw Pact Theater Forces and Doctrine, 1988-2007*; and NIE 11-4-89, *Soviet Strategy Toward the West: The Gorbachev Challenge*.

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Discussion⁴

The Need for Change

A simple growth formula—ever increasing inputs of labor and capital—resulted in rapid economic gains for the Soviet Union in the postwar era. This postwar system placed heavy stress on quantity rather than quality. Because there was an abundance of low-cost, readily available resources, there was little concern for efficiency and productivity. As the USSR moved out of the reconstruction phase in the 1960s, this growth formula became less effective. Labor supply growth slowed, ever larger expenditures were required to exploit natural resources, and the inefficiencies inherent in central planning became more acute as the economy grew.

Military spending also has increasingly hindered economic performance. To support the military effort, Moscow created an institutional mechanism reaching from the highest state bodies down through layers of administrative control to individual enterprises, thus ensuring priority to defense programs. As a result of this priority, the defense sector's share of national output grew and by the mid-1980s consumed 15 to 17 percent of GNP. The incentive structure—wages, bonuses, perquisites—was designed to favor those who worked in or supported the defense industry. The defense sector was given priority access to raw materials, machinery and equipment, subcomponents, scientists, engineers, and skilled workers, preempting consumption and investment in the civilian sector. The

⁴ General Secretary Gorbachev's efforts at reforming the political and economic fabric of the Soviet Union have been under way for more than three years. This Estimate reviews the progress of his economic strategy, identifies the conflicts inherent in his approach, and assesses the outlook for reform over the next five years. The Soviet leader has set in motion a dynamic process whose outcome cannot be predicted with confidence. There will continue to be major alterations in the game plan, and a conservative reaction to the strains unleashed by the current effort is possible. What is clear is that the very fabric of Soviet ideology and institutions is being questioned more than at any time since the revolution, and in the Soviet Union there is a general consensus that retreating to the economic and political path existing when Gorbachev took over is not tenable.

Soviet defense industry became the most technologically advanced and most effective sector of the economy. This effectiveness was due primarily to the priority that created the institutional mechanism rather than greater efficiency. The defense industry has been at least as inefficient and wasteful as the civilian sector.

As a result of these factors, GNP growth slowed from rates that were closing the economic and technological gaps with the developed West during the 1950s⁴ and 1960s to a range in the 1980s that allowed little expansion of per capita output and stymied progress in narrowing the technology gap. The large and still growing burden of defense coupled with increasing demands for investment in areas such as energy and agriculture allowed no room for major increases in the quantity and quality of consumer goods and services.

Brezhnev's successors, then, were saddled with:

- An antiquated industrial base and a defense sector that was siphoning off high-quality resources needed for economic improvement.
- An energy sector beset by rapidly rising production costs of oil, its major fuel.
- Levels of technology that, for most areas, substantially lagged those of the West.
- Inefficiencies inherent in the conflict between ever more central planning and control and an increasingly large and complex economy.
- An inefficient farm sector that, despite large investments, still employed 20 percent of the Soviet labor force compared with only 5 percent in the United States.

Figure 1
USSR: Low Living Standards

Soviet consumption as a percentage of US consumption, 1983

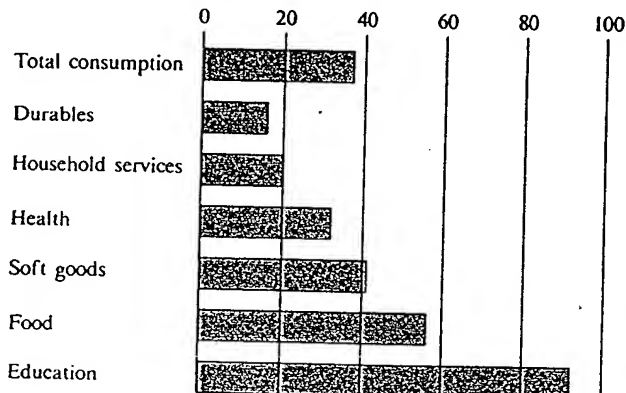
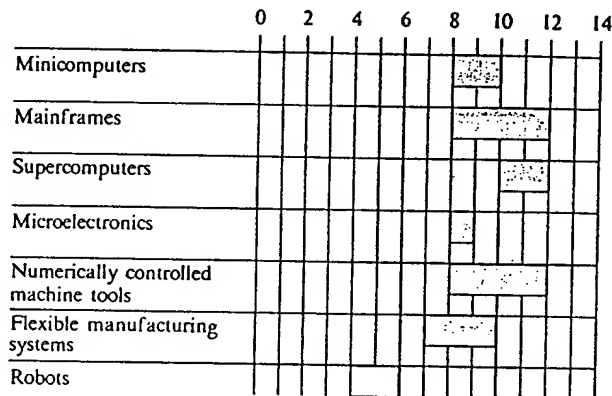


Figure 2
USSR: Lags in Key Technologies

Approximate length of US lead in years



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- A hidebound, corrupt bureaucracy and inflexible planning system that failed to provide the proper signals for production and investment, retarded scientific-technical innovation, and encouraged high costs and massive waste of resources.

A Bold Action Plan

Gorbachev recognized the "pre-crisis" urgency of these problems and initiated a bold strategy to deal with them. He grouped his efforts to revive the economy under the broad rubric of *perestroyka*, a term that includes three major economic elements—lighter *economic discipline*, *industrial modernization*, and *economic reform*. The goal of these actions, we believe, is to develop an economic environment capable of:

- At least containing, if not narrowing, the growing gaps in technology and economic performance with the West, thereby also enabling Moscow to maintain its military competitiveness.

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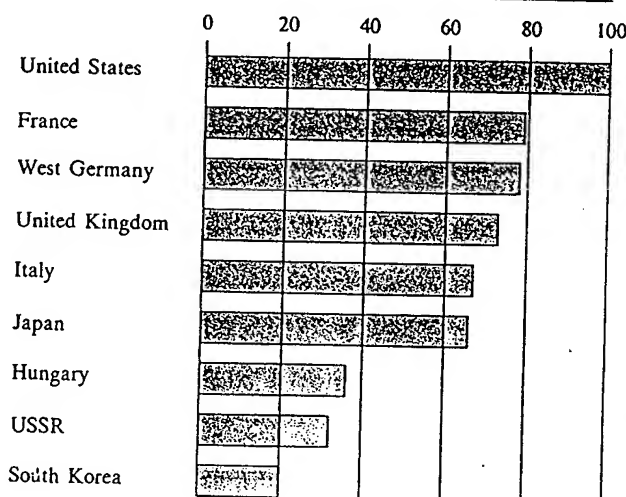
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- Achieving major improvements in consumer welfare to gain the cooperation and support of the masses for *perestroyka* and to maintain regime legitimacy. Gorbachev and other Soviet leaders recognize that reaching these economic goals will take years, possibly decades, and that progress toward them could be greatly facilitated by a more nonconfrontational international environment. Gorbachev's efforts in arms control, his political initiatives, and the campaign to refurbish the USSR's image are intended to achieve such an environment.

When Gorbachev first assumed office, he concentrated on extending and intensifying Andropov's *discipline* campaign. His "human factors" initiatives—discipline, temperance, and improved work incentives—were intended to raise labor productivity and to increase economic growth for the first two or three years of the 1986-90 Five-Year Plan while industry retooled. He also removed many inept and corrupt managers and officials and attempted to rationalize

Figure 3
USSR: Per Capita Consumption in a
Global Perspective, 1985

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the organizational structure of the bureaucracy by trimming slots and rearranging and combining functions.

Gorbachev argued that *industrial modernization* was the key to long-lasting improvement of the USSR's economic situation. His program was aimed at the massive introduction of new machinery and the rapid retirement of old equipment. This depended heavily on major improvements in the machine-building and metalworking sector that manufactures producer and consumer durables and military hardware. (See inset, "Machine Building—The Focus of Gorbachev's Modernization Plans.")

Gorbachev's boldest proposals were focused on *economic reform* of planning and management. These changes—contained in the Basic Provisions for Fundamentally Reorganizing Economic Management, the

Law on the State Enterprise, and 11 decrees—were approved at the Central Committee plenum in June 1987. This set of documents, together with decrees adopted over the last three years that expanded the role of the private sector, represents a design for the most comprehensive reform of economic management in the Soviet Union since the introduction of Stalinist central planning in the late 1920s. The plan goes well beyond the "Kosygin" reforms adopted in 1965 (see annex A). The reform package is scheduled to be "almost fully" in place by the beginning of 1991—the first year of the 13th Five-Year Plan—and major parts of the package are already in effect. (See the table on pages 5 and 6.)

Clearing the Political Track

Gorbachev also proposed reforms of the political system in part because of the ability of the entrenched state and party bureaucracies to defeat past efforts at economic reform. He aims to decentralize the political system to circumvent the resistance to reform at the top and middle levels of the leadership—groups that have forced him to compromise and slow implementation of his programs. The reforms place more decisionmaking authority at the local level in hopes of making the system more responsive to local economic signals than to administrative dictates from the top. His program for "democratization" is designed to produce a more participatory political culture—encouraging local officials to take initiative to resolve problems and giving the populace a greater say in decisions.

At Gorbachev's initiative, measures were approved by the national party conference in June 1988 to reduce the size of the party apparatus, force local party chiefs to stand for election as head of the regional soviets, and give the soviets new authority. These measures aim at diminishing the ability of local party chiefs to block controversial reforms and sensitizing local leaders to popular sentiment on such economic issues as more and better food and consumer goods. *Glasnost*—an element of political reform in the broadest

Machine Building—The Focus of Gorbachev's Modernization Plans

Gorbachev has argued that the key to long-lasting improvement of the USSR's economic situation is the continuous introduction of increasingly productive machinery and equipment. The modernization program, therefore, depends heavily on improvements in machine building and metalworking—the sector that produces these producer durables, as well as consumer durables and military hardware. The ambitious targets of the 1986-90 plan reflect the sector's importance:

- *Output is to increase by 43 percent during the period 1986-90.*
- *Targets for high-technology equipment are even higher. Planned growth rates are especially high for numerically controlled machine tools (125 percent), robots (225 percent), and processing centers (330 percent).*
- *Quality and technological levels are to improve dramatically. By 1990, 85 to 90 percent of the most important types of machinery output will be up to "world technical levels," compared with 13 to 15 percent for civilian machinery in 1986. New machinery is to be at least 50 to 100 percent more productive and reliable than previously produced equipment.*
- *New machinery is to be introduced more quickly than in the past—by 1990, 13 percent of machine-building output is to be in its first year of production, up from 3 percent in 1985.*
- *By 1990, 60 percent of the sector's own machinery is to be new—that is, brought on line during the preceding five years. To reach this goal, investment in civil machine-building ministries is*

to rise by 80 percent. Meanwhile, the withdrawal rate for old capital goods is to double by 1990, while the withdrawal rate for machinery is to quadruple.

Machine building's struggle to meet these goals was hindered, in part, by the quality control program and new financial arrangements introduced in 1987:

- *Production of numerically controlled machine tools showed no growth in 1987, and production of industrial robots declined.*
- *While newly introduced machines represent about 9 percent of output, the Soviets admit to a general lack of progress in meeting "world standards."*
- *The pace of both investment and machinery retirements has slowed markedly from the plan guidelines.*

Though machine builders will not reach their 12th Five-Year Plan targets, the leadership has taken steps to revitalize modernization by refocusing resources on priority areas including machinery for consumers, the food program, transportation, and construction. At the same time, the plan calls for an intensification of the development of machine tool building, instrument building, electronics, and electrical equipment—the same industries targeted for preferential development in the original 12th Five-Year Plan goals.

Soviet Economic Reform: A Status Report

Reform	Major Purpose	1989 Goals	1988 Results	Final Objective
Enterprise self-financing	Enterprises will bear full economic responsibility for the results of their activity. Investment will be financed less through budget allocations and more through enterprise's own resources and bank credits.	100 percent of industry and agriculture; "hope" to complete changeover of nonproduction sphere to same principles.	60 percent of volume of output in the economy.	Same as 1989 goals.
Regional/local self-financing	Republics and local governments will have greater role in forming their own budgets and will be expected to balance revenues and expenditures. Revenues will be formed from taxes levied on enterprises within the region or locale to fund social/economic development.	Estonia, Latvia, Lithuania, Belorussia, Moscow City, Tatar ASSR, and Sverdlovsk Oblast (RSFSR).	Not yet introduced.	Expansion to unnamed regions.
Planning	Enterprises will produce a portion of their output in compliance with mandatory state orders and will be given greater latitude in determining the remainder.	All enterprises and associations. State orders are to make up an estimated 40 percent of industrial production.	State orders made up 86 percent of industrial production.	State orders are to "eventually" drop to 20 to 25 percent of total production.
Supply	Only "scarce" producer goods and supplies for state orders will continue to be rationed by the state. Other supplies will be distributed through a wholesale trade system that will allow free purchase and sale under direct contracts between providers and users.	Approximately 10 percent of total industrial production; 50 to 55 percent of sales through state supply networks. ^a	Over 4 percent of total industrial production operated under wholesale trade.	Wholesale trade reform to cover more than 70 percent of sales through state supply networks by 1992. ^b
Wages	Entire wage and salary structure in the production sector will be overhauled, but increases are dependent upon enterprise's ability to finance them and are tied to increases in labor production.	No announced goal. 1988 goal was 60 to 70 percent of the work force. (May not be expanded because of concern that wages are being increased more than increases in labor productivity.)	No information.	All industrial sectors by end of 1990.
Banking	Decentralizes bank decisionmaking somewhat and elevates the role of economic criteria in extending credit.	Codification of banking practice through new banking legislation.	Limited decentralization. Some flexibility in negotiating lending rates. Assumed role of liquidators in cases of insolvency.	After price reforms are implemented.
Foreign trade	Allows selected enterprises to engage directly in foreign trade and keep portion of foreign currency earned.	Unannounced.	Was to be 26 percent of all imports and 14 percent of all exports. (Implementation behind schedule.)	No date given.

Footnotes appear at end of table.

Soviet Economic Reform: A Status Report (continued)

Reform	Major Purpose	1989 Goals	1988 Results	Final Objective
Wholesale prices	Will be revised to better reflect resource scarcity and customer demands and will be based on contracts.	Not scheduled to be implemented.	Not scheduled to be implemented.	Industry, transportation, and communications by 1 January 1990; construction and agriculture by 1 January 1991.
Retail prices	Will be made more flexible and more fully reflective of supply and demand, probably resulting in higher prices for food, rent, and consumer services.	None; to begin only after full public discussion and before 1991 (beginning of 13th Five-Year Plan).	Not scheduled to be implemented.	Whole economy, presumably including retail by 1991.

^a This goal was moved up to 1989 from 1990. In 1987, the stated 1989 goal was to be 30 percent of sales through state supply networks operating on wholesale trade.

^b This goal was slightly reduced. In 1987, the stated 1992 objective was for wholesale trade to cover 80 percent of sales through state supply networks.

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sense—encourages the critical reexamination of economic history and the Stalinist system's ideological foundations and provides a new set of precepts that support the devolution of economic and political power. (See inset, "Challenging Accepted Norms.")

Slow Progress

Implementation of Gorbachev's program is off to a rocky start. This is particularly true of his attempts to reform the system of planning and management. Ministries have not clearly apprised enterprise managers of their new tasks and responsibilities. Detailed instructions have not been issued, nor have chains of command in new organizations been delineated clearly. Enterprise managers remain reluctant to take risks and to focus on quality and innovation because pressure remains to meet quantitative targets set in the extremely ambitious original five-year plan.

Loopholes in the reform legislation—the result of compromise between those who wanted a radical decentralization of economic decision making immediately and those who preferred a more traditional, cautious approach—have allowed the ministries and the planning bureaucracy to resist change and have postponed the advent of market forces:

- For example, although obligatory plan targets covering an enterprise's entire range of output have been replaced by a system of "nonbinding" control figures and mandatory state orders, during the first year of implementation, state orders levied by Gosplan and the ministries often took all of an enterprise's output. In an effort to solve this problem, ministries are prohibited from issuing state orders during 1989, and Gosplan is instructed to reduce state orders by one-half to two-thirds.

Challenging Accepted Norms

Initiatives

Initiatives to make enterprises more financially independent would inevitably result in the bankruptcy of inefficient firms.

Wage reform would tie rewards more closely to individual production results and would give greater rewards to professionals and skilled workers.

Retail price reform would reduce government subsidies and bring supply and demand more into line.

Wholesale price reform would allow prices to reflect changes in resource scarcities and consumer demand.

Expansion of the private sector to increase the availability of consumer goods and services would unleash private initiative.

Workplace democratization would allow the workers to elect their managers and workers councils, giving them a greater stake in the collective's success.

The cooperative movement in agriculture would give the farmer a personal interest in using the land more efficiently by allowing him to contract with the farm and to pocket the profits.

Conflicts

This creates major uncertainties for workers, who face unemployment and/or retraining, and for the manager, a member of the privileged elite, who has typically spent his entire career at the same plant.

This eliminates wage leveling and creates pressures to fire redundant workers, thus conflicting with the social contract.

While needed ultimately for long-term reform, it would weaken the safety net that gives the poorest segment of the population assured access to necessities such as food, housing, and health care.

It would allow the market more influence over Soviet economic activity, increasing the potential for its reputed evils—inflation, unemployment, "unearned" profits, and cyclical fluctuations.

It encourages qualities previously eschewed in the making of the "new Soviet man"—self-interest, competition, and "money-grubbing"—while it chips away at state ownership of the means of production.

Democratization violates the Lenin-ordained principle of one-man plant management and gives the workers a greater potential to challenge the role of the party in the economy.

*It appears to be at variance with the *raison d'être* for collectivization—the submergence of the individual to the group and a mechanism to transfer dividends from agriculture to other sectors.*

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- Under the new conditions of "self-financing," enterprises are to finance operating expenses and some capital expenditures out of their own revenues and bear the full economic responsibility for their actions. However, the amount of revenues they are permitted to keep and the distribution of these resources among investment and incentive funds remain under the control of the ministries. As a result, the ministries are able to juggle these accounts and use the earnings of profitable enterprises to bail out the unprofitable ones.

In the area of foreign trade, a "stage-by-stage" convertibility of the ruble is planned, starting with the currencies of the countries belonging to the Council for Mutual Economic Assistance. Enterprises also are being given broader rights to keep part of the foreign exchange earned from exports. However, they still need approval to participate directly in foreign economic activity, and Soviet economists admit that currency convertibility, even with the currencies of Eastern Europe, is far off.

Finally, implementation of Gorbachev's program is slow because only a portion of the economy has changed to the new system, and crucial elements of the reform package are not scheduled for full implementation until the beginning of the 13th Five-Year Plan in 1991. Wholesale and retail price reform is essential to make other reforms work, such as self-financing and making the ruble more convertible into both domestic goods and foreign currencies at realistic rates. Yet, wholesale price reform in the state sector will not be completed until 1991 and is likely to consist of administrative revisions rather than changes in the way prices are determined. Retail price reform has been postponed indefinitely because the regime fears that it will corrode the support of the populace for *perestroyka*. Substantial new flexibility in setting prices, as reformers originally intended, is not likely because the Soviets have seen that granting limited enterprise rights to set prices has been inflationary under monopolistic conditions. (See inset, "Backtracking on Reform.")

The modernization program has also been lagging and seems to be getting a reduced level of attention. In 1987 there was no increase in the output of machinery for the civilian sector, and the resulting shortfalls in

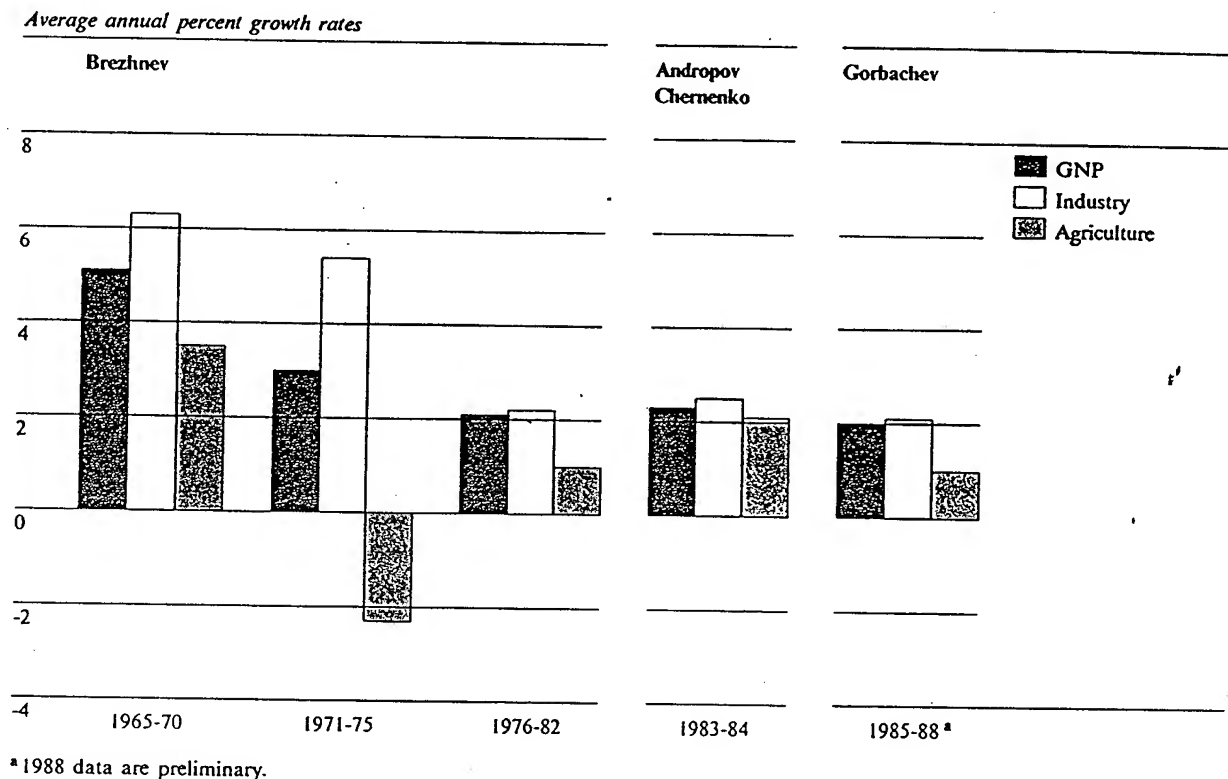
Backtracking on Reform

Some economic reforms, particularly those that would negatively affect the consumer, have been delayed or modified:

- *Retail price reform, which was to be implemented in 1991 along with wholesale price reform, has been pushed into the indefinite future; even reform economists are expressing skepticism about its wisdom.*
- *Consumer goods remain tied to state orders in order to ensure that unprofitable goods will be produced; state orders have been reduced substantially in other sectors.*
- *A new set of price regulations on goods and services produced in the cooperative sector are in response to public complaints of price gouging.*
- *Decisions on wage increases, which were to be the preserve of the enterprise, now are monitored by Gosbank in order to ensure that they do not exceed productivity gains and add to inflationary pressures.*
- *Wholesale price reform that will be implemented beginning in 1990 is not the reform of the price mechanism itself as envisioned in the original reform decree, but another revision that will periodically need adjusting.*

equipment for investment caused problems throughout industry and the rest of the economy. The high targets that machine builders were tasked to achieve were overwhelming, particularly in light of the fact that they were being forced to do everything at once: retool, increase quality, conserve resources, change the product mix, and accelerate production. Despite some performance improvement in 1988, the program remains well below target.

Figure 4
USSR: Economic Performance Under Gorbachev and His Predecessors



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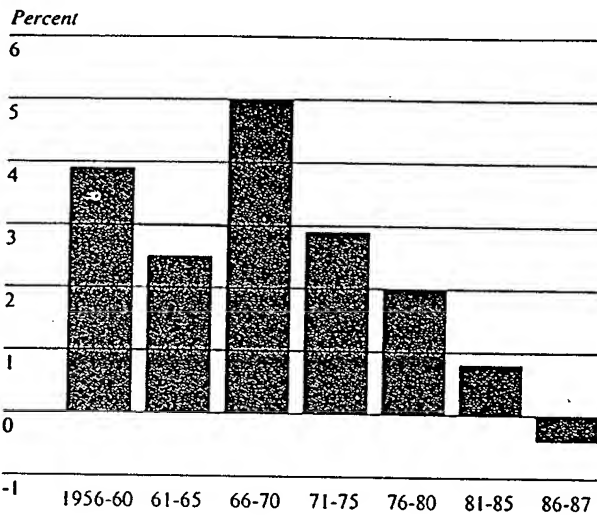
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Gorbachev's economic program has so far failed consumers. Economic performance during 1985-88 was about the same as in 1976-82—the most stagnant Brezhnev years when per capita income did not grow. The effects of this poor performance—coupled with reduced imports of consumer goods and the antialcohol campaign—mean that Soviet consumers probably felt somewhat worse off at the end of 1987 than they did in early 1985 when Gorbachev assumed the post of General Secretary. The Soviet consumer scene is still marked by lengthy queues, rationing of some goods, pervasive black-market activity, and shortages of basic necessities, especially food.

Altering Economic Strategy

Because of these mounting problems, Gorbachev has begun to alter his strategy in an attempt to revitalize his economic program and prepare for the planning decisions for the next five-year plan (1991-95). The potential problems from disgruntled consumers forced Gorbachev to alter his investment strategy to place more emphasis on housing, food processing, and light industry and to restrict growth in some other sectors. The Soviets have directed the machine-building industry to give priority to sectors that directly serve the consumer.

Figure 5
USSR: Average Annual Growth of
Per Capita Consumption, 1956-87



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The defense industry is also being told to assume responsibility for a greater share of consumer-related production:

- Premier Ryzhkov directed the defense industry to increase deliveries of equipment to the food-processing sector.
- The Ministry of Machine Building for Light and Foods Industry and Household Appliances was disbanded and most plants resubordinated to the defense industry.
- The 1989 plan calls on the defense industry to improve the quality and increase production of consumer goods and capital equipment for consumer-related industries.
- The Minister of Medium Machine Building (the most secretive defense-industrial ministry) announced plans to increase sharply the output of equipment for the dairy industry.

Gorbachev is increasingly concentrating on expanding the private and cooperative sectors and offering long-term leasing arrangements in both agriculture and

industry because those initiatives hold the best prospects for producing considerable improvements in the quality of life over the next five years. Legislation that would have levied a prohibitive tax structure on cooperatives was remanded in July by the Supreme Soviet in an unprecedented move.

Outlook

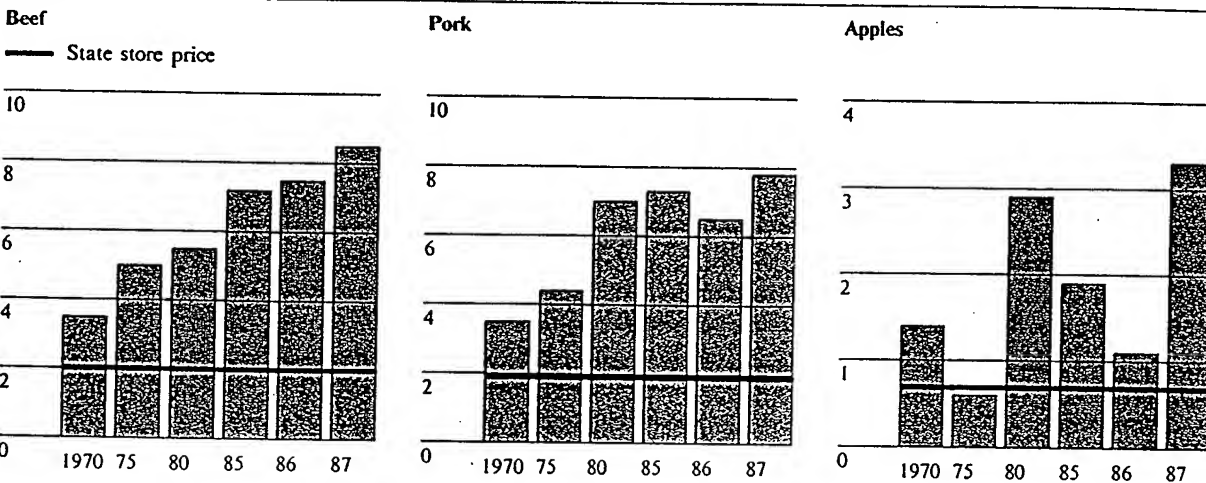
We believe that Gorbachev's efforts at reforming the economy, fostering capital renewal, and motivating labor and management will produce no substantial improvement in the Soviet economy over the next five years.⁵ His efforts to devote increasing resources and attention to improving consumer welfare, however, could achieve some modest results. Still, we believe Gorbachev will be disappointed with the overall consequences. Squeezing investment growth in nonconsumer sectors, including heavy industry, will jeopardize prospects for meeting vital production targets. This same strategy resulted in serious bottlenecks and a substantial slippage in industrial growth during the period 1976-80. Plans to increase investment in light industry and to buy Western manufacturing equipment face long-drawn-out retooling and installation processes. Gorbachev's failure to deal with the already large budget deficit will intensify inflationary pressures. (See annex B.)

Soviet attempts to incorporate new technologies and create a more productive labor force will not be enough to narrow the technology gap in most sectors with the West during the remainder of this century. More important, gains in particular areas will not be self-perpetuating as long as incentives for dynamic technological change remain weak. The Soviets have undertaken a variety of measures to spur innovation and the introduction of new technologies, including: (1) raising prices for innovative products; (2) forming associations to gather research, development, and production responsibilities under one roof; (3) making

⁵ The Director, Defense Intelligence Agency, believes that this uneven performance could include sufficient improvement in the Soviets' economic and technical base to facilitate fulfillment of future military requirements.

Figure 6
Moscow: Collective Farm Market Prices
of Selected Goods^a

Rubles per kilogram Note scale changes



^a Data are for purchases made in Moscow in August or September of each year.

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information more available as a result of *glasnost*; and (4) encouraging joint ventures and technical exchanges with the more advanced countries. Nevertheless, systemic obstacles remain that discourage the introduction and dispersion of new technologies at industrial enterprises.⁶ Recent reforms aim at creating conditions and incentives for greater "technology pull" from below and expanding the autonomy of research and production collectives, but we believe these first faltering steps will not produce substantial results during the period covered by this Estimate. Acquisition of technology aimed toward military uses will not provide advances in Soviet industrial applications—the cornerstone of Soviet modernization. On the other hand, the new proposed forms of cooperative sharing of technology and managerial techniques with

the West, particularly joint ventures, could allow for easier transfer of technology than has been the case with traditional purchases of machinery and equipment.⁷

There may be some economic benefits from the reform program that will help to prevent further deterioration in the planned economy. For example, financial pressures on enterprises should help reduce redundant labor and some waste of materials. On balance, however, we believe that such benefits will be slow in coming and that they will be outweighed by disruptions resulting from the conflicting and changing signals that piecemeal implementation of the reform program will continue to create.

⁶ The Director, Defense Intelligence Agency, believes that, since the Soviets already lead in several key defense technologies, they should be able to continue assimilating technology gains in this sector.

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We see no evidence that Gorbachev currently intends to impose more radical reform in the state sector, a strategy that would include:

- Disengaging enterprises completely from ministerial control and allowing them to respond to economic levers.
- Providing much better price and profit signals by allowing prices to fluctuate in response to supply and demand.
- Creating a more competitive environment by breaking up the present huge production conglomerates and permitting competition from abroad.
- Introducing financial and capital markets.

Such moves toward a market economy at this time would be even more disruptive to the planned economy than piecemeal implementation and in particular would jeopardize Gorbachev's campaign to win popular support for his programs. We believe it most likely that reforms for the state sector will continue to be implemented slowly. Only a small number of unprofitable firms will be shut down, and price reform will entail the periodic revision of prices rather than a change in the basic pricing mechanism to allow more flexibility. Nevertheless, Gorbachev has often reacted to setbacks by proposing increasingly radical measures, and we cannot rule out an effort to move rapidly toward a market economy in the state sector. (See annex C.)

We believe Gorbachev will continue to push forward on the moves already begun to expand private initiative by paving the way for growth in the private and cooperative sectors and by allowing long-term agricultural leases. For such reforms to work, however, Moscow must allow more flexibility and reliance on the market. We believe progress in this area will be difficult because a resentful public and skeptical local authorities are likely to continue retarding the development of the private sector. Furthermore, the lease contracting system in agriculture will probably remain bound by centrally directed procurement targets and state supplies of inputs as well as a recalcitrant bureaucracy. Goods supplied by the private sector will be costly, raising concerns over inflation. An added problem for Moscow is that these reforms probably will be most successful, at least initially, in non-Russian areas such as the Baltic states and the Caucasus.

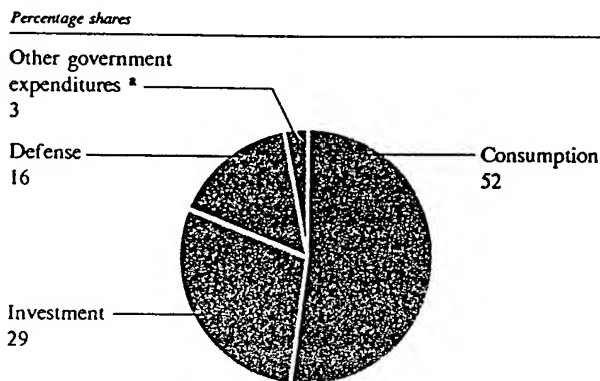
We believe there will be escalating conflicts over resources as the industrial modernization program falls short, consumers continue to clamor for tangible rewards, and the military perceives no reduction in its needs. In the near term, the resource allocation debate will be sharpest on investment. The present five-year plan has no slack that would permit greater investment in priority sectors without offsetting adjustments in other areas. The regime continues to balance the books on the investment program by assuming large gains in productivity in key areas such as machine building, agriculture, industrial materials, and construction. Yet, in his three-plus years in power, Gorbachev has not made any progress in reversing the long-term decline in productivity.

As a result, the leadership will have to tap resources outside the civilian machinery-production sector to continue the high investment strategy needed to renew the USSR's capital stock and improve productivity over the long term. As a large claimant on some of the economy's most valuable and productive resources, the defense industry is the prime, but not the only, candidate that will be tasked to support Gorbachev's industrial modernization drive. The defense industry already produces civilian investment goods and is the main source of some high-technology machinery and equipment such as robots, computers, and advanced machine tools both for its own use and for the civilian economy.

The defense industry has been given additional assignments to support the civilian sector and has been told that these civil projects must be given priority, even at the expense of some defense activities. We judge Gorbachev will divert additional resources from defense—including managers, equipment designers, investment funds, and plant capacity—to his civilian programs. The unilateral force reductions recently announced by Gorbachev could pave the way for cutbacks in weapons procurement in the near term, which will release defense industry resources for Gorbachev's civil economic agenda. While we recognize there is some redundant defense plant capacity, significant increases in the production of goods for the

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Figure 7
Estimated Distribution of Soviet GNP
by End Use



* Administration, other services, and civilian research and development.

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civilian sector beyond the short term would require a diversion of resources from the military. Some members of the military have acknowledged that defense must endure some pain under *perestroika* to help the economy and, hence, its own needs down the line. Nevertheless, diversion of resources from defense to civilian objectives will escalate conflicts over resource allocation because it could delay upgrades to weapons plants, thereby postponing the introduction of new systems. Clearly there are strong economic pressures for major reductions in military spending. The full extent of these trade-offs will be based on an ongoing decisionmaking and bureaucratic process that will continue over the scope of the Estimate.

The Director, Defense Intelligence Agency, holds the view that a critical distinction must be made in the discussion of resource allocation trade-offs between the resource requirements for short-term objectives and those of long-range goals. Short-term requirements will rely primarily upon existing plant capacity and inputs. The demands Gorbachev is making on the defense sector do not require significant short-term reallocations from defense to the civilian sector or the disruption of current procurement programs. In the

longer term, to achieve lasting gains in productivity, significant investment resources will be required. Redirecting investment going to the defense industry would not be sufficient to meet the economy's modernization requirements since other sectors take far greater shares of total investment. While slowing the flow of investment resources into the defense sector may well result in a downward turn in defense spending trends, the Soviets probably would maintain weapons programs that are key to force modernization, while stretching some lower priority programs and phasing out early some long-established weapons production runs.

The accumulating economic problems and the challenges posed by the simultaneous pursuit of economic and political reform will raise the level of contention higher than it has been so far in Gorbachev's tenure. As a result of these tensions and continued struggles over resource allocation, we believe there is some risk for Gorbachev's economic program. In the area of economic reform in particular, disruptions—widespread reform-related work stoppages or a drastic drop in performance indicators—would strengthen conservative opposition and convert to opponents those who have been only lukewarm supporters of reform. Such trends—coupled with the effects of *glasnost* and continuing nationality turmoil—could force the leadership into major retreat. If this should happen, the more orthodox elements of Gorbachev's program would survive, but the reforms designed to bring about a major decentralization of economic decision making would be shelved.

Implications for the West

On Arms Control

Gorbachev's initiatives in the arms control arena have been supported by development of "new thinking" in the formulation of national security policy. Three leading themes of this new policy are:

- *The economic dimension of national security.* Soviet leaders have linked an improved economy to the expansion of the USSR's influence, and they have

contended that the challenge posed by the arms race to Moscow's superpower status is as much economic as it is military. They and the military leadership agree that significant improvements in the high-technology sector of the economy are essential to compete with future Western weapon systems.

- *The limits of military power.* Gorbachev has tried to promote a concept of "mutual security" that attaches greater weight to political factors.
- *"Reasonable sufficiency."* Gorbachev and his followers have characterized this concept as having the necessary forces to deter aggression, and they have indicated that the Soviets already have sufficient power to do so. The Party Congress in February 1986, moreover, endorsed Gorbachev's call to "restrict military power within the bounds of reasonable sufficiency."

In addition to trying to redefine Soviet national security requirements, we believe Gorbachev has moved arms control to the forefront of the USSR's national security agenda in an effort to dampen both external and internal pressures to spend more on defense, at least until he can reap the productivity gains he hopes to achieve from his industrial modernization program. With more than 150 Soviet Ground Forces divisions, 160 Soviet Air Forces regiments, and 50 Soviet Air Defense Forces regiments west of the Ural Mountains, any type of accommodation with NATO that would allow the Soviets to reduce expenditures on modernizing these forces has the potential to result in substantial resource savings. The Soviet leadership probably hopes that the process of arms control negotiations will weaken NATO's resolve to modernize conventional and tactical nuclear weapons—thus making possible cuts in their own defense spending.

The unilateral force reductions recently announced by Gorbachev could pave the way for cutbacks in weapons procurement in the years ahead. The amount saved will depend on the forces affected, the restructuring of remaining forces to give them what Gorbachev described as a "clearly defensive" orientation, the pace at which the reduced force is modernized, and the costs of carrying out these initiatives.

A plausible long-term method of transferring resources would be to redirect future investment from defense industries into the civilian sector during the next five-year plan (1991-95). As a result of the large-scale modernization in the defense industries in the 1970s, the defense sector has already in place most of the equipment it needs to produce weapon systems scheduled for deployment through the early 1990s. But the high-quality machine tools, equipment, and raw materials required to retool the defense industry to produce the next generation of weapons are the same resources needed for Gorbachev's industrial modernization program.

For Eastern Europe and Soviet Client States

Attempts at political reform in the USSR are likely to generate pressure on East European countries for similar reforms. Moscow will also increase its demands on them for more and higher quality machinery and consumer goods and for greater participation in joint projects—particularly those involving the exploitation of Soviet natural resources. East European countries will also be asked to shoulder more of the costs of the Warsaw Pact defense effort. We believe these countries—which are facing economic constraints and are anxious to do hard currency business with the West—will be able to resist most of these demands successfully.⁴

As to relations with client states, we expect increased pressure from Moscow for those countries to adopt reforms in order to reduce the burden of Soviet support. While such support is only a limited drain on resources, Gorbachev apparently believes that it is inconsistent to continue support at past levels to countries, such as Cuba and Vietnam, that are not willing to adopt more flexible economic policies.

In Commercial Relations

We do not foresee a large, sustained increase in Soviet imports from the technologically advanced capitalist countries. Poor Soviet export prospects mean that such an increase would have to be financed either by a

⁴ For further details, see NIE 11/12-9-88 May 1988, *Soviet Policy Toward Eastern Europe Under Gorbachev*.

substantial runup of debt, which Soviet officials insist they will avoid, or by accelerated gold sales, which could risk significant reduction in world gold prices. In this regard, the situation facing Moscow in 1988 is far different from the USSR's position in the early-to-middle 1970s, when the Soviets could easily manage a substantial increase in their debt to the West:

- Now Moscow must contend with stable or declining oil prices and uncertainties over the quantity of oil available for export.
- Much of the debt incurred in the 1970s was formally tied to Western agreements to purchase Soviet raw materials. This option is currently being used more selectively.

Moreover, although the Soviets recognize the potential gains from increased use of Western technology and equipment, they lack the confidence in the ability of the economy—as currently configured—effectively to absorb and ultimately to diffuse imported technology on a large scale.

We cannot rule out a temporary sharp increase in imports of consumer goods as a stopgap measure, given the leadership's concern over the lack of popular support for Gorbachev's programs. Even such an increase would only restore Soviet spending on consumer goods imports to pre-1985 levels. The Soviets cut back substantially on imports of consumer goods at that time in response to a large reduction in export earnings. In recent months Western banks have been negotiating credit lines with the Soviet Union worth between \$6 billion and \$9 billion—largely tied to Soviet purchases of machinery and equipment for the production of consumer goods. In the past the Soviets have arranged such lines and not used them fully, and it is currently unclear to what extent they will use these newly acquired credit lines. Unlike the mid-1970s, when credit competition among Western governments worked to the Soviets' financial as well as political advantage, the new credit lines do not offer preferential financing, nor do they otherwise materially broaden the potential base for Soviet borrowing.

A surge in borrowing from the West would not aid the Soviet economy significantly or ameliorate the resource competition between the military and civilian

sectors. For example, even borrowing as much as Western bankers would allow—perhaps \$3-4 billion net annually in addition to the roughly \$5 billion needed per year to refinance maturing debt—would provide only a drop in the bucket for an economy that produces roughly \$2 trillion worth of goods and services annually. We believe the Soviet leadership will not undertake such borrowings for fear of the economic leverage it would give Western governments and bankers. Moreover, the Soviets recognize that plans for any debt buildup can go awry should Moscow unexpectedly confront lower oil prices, further depreciation of the dollar, or two consecutive bad harvests.

We expect to see an intensification of Soviet foreign economic initiatives, including increased concessions to Western firms to conclude joint-venture agreements, greater efforts to learn from Western businessmen, a stepped-up campaign for GATT membership, and the possible release of more trade and financial data to facilitate improved borrowing terms. (See annex D.) Under these conditions Soviet hard currency trade will continue to be dominated by Western Europe and Japan. The Soviets also will push hard as a top priority to improve economic relations with the European Community.

The Soviets will continue to press for trade and possibly financial concessions from the West. This will lead to increased pressures for the West to pare further the list of COCOM-controlled technologies. Such pressure will make it more difficult for the West to maintain a unified stance on current agreements—or reach a new consensus—concerning trade and financial flows to the Soviet Bloc.

For Western Leverage

Given the severity of Soviet economic problems, Gorbachev needs the many benefits of a nonconfrontational international environment. This gives the United States and its allies considerable leverage in bargaining with the Soviets over the terms of that environment on some security issues such as regional conflicts and arms control and on some internal

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matters such as human rights and information exchange. The margins of this leverage will be set by Moscow's determination not to let the West affect the fundamental nature of the Soviet system or its super-power status.⁹

⁹ For a fuller discussion of these issues, see SNIE 11-16-88, *Soviet Policy During the Next Phase of Arms Control in Europe*, November 1988; NIE 11-3/8-88, *Soviet Forces and Capabilities for Strategic Nuclear Conflict Through the Late 1990s (Volume I)*, December 1988; and the forthcoming Estimates NIE 11-14-88, *Trends and Developments in Warsaw Pact Theater Forces and Doctrine, 1988-2007*; and NIE 11-4-89, *Soviet Strategy Toward the West: The Gorbachev Challenge*.

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Annex A

The "Kosygin Reform"

As outlined by Kosygin, the 1965 reform program was to include an administrative reorganization of the bureaucracy, some decentralization of planning and decisionmaking functions from the ministries to the enterprises, a change in success criteria for enterprises, a revision of wholesale prices, and a reform of the industrial supply system.

In comparison, Gorbachev's reform program is much more comprehensive and integrated, encompassing other key elements. For example, his price reform, unlike previous efforts, is designed to encompass all forms of prices—wholesale, procurement, and retail—and, in theory, is intended to change the basic pricing mechanism.

The 1965 reforms were handicapped by major economic flaws and inconsistencies. But they foundered largely because of opposition from the government bureaucracy, which reacted by procrastinating, assimilating, complicating, and regulating. Implementation of the reform also suffered from a lack of strong

leadership backing. Its initiator, Kosygin, became increasingly overshadowed by Brezhnev, who lacked his predecessor's commitment to reform. The climate for a decentralization of decisionmaking became even less favorable after the Czechoslovak "spring" of 1968, which underscored the political risks of reform. Consequently, the reform was never implemented as initially intended.

Annex B

The Budget Deficit

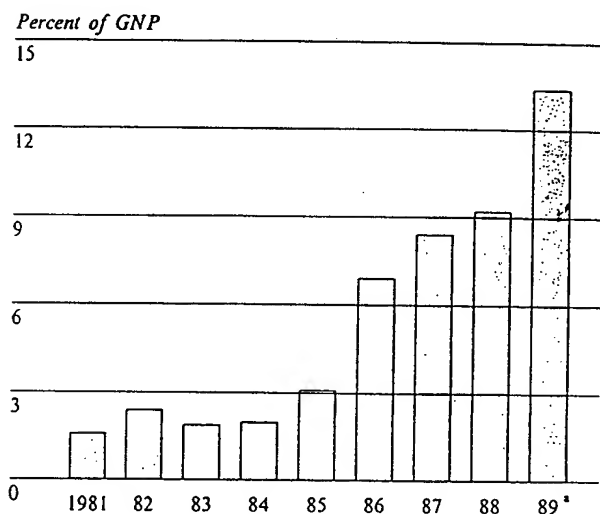
The Soviet state budget deficit has increased dramatically during the last three years. We calculate the 1989 deficit will be about 125 billion rubles—some 13 percent of Soviet GNP. (For comparison, the highest US Government budget deficit represented 3.5 percent of US GNP in fiscal year 1986.)

The inflationary pressures resulting from Moscow's fiscal policy are already visible. Growth of wages almost doubled in the first half of 1988. There has been a marked increase in the prices of consumer goods sold in collective farm markets, along with higher prices and increased shortages of consumer goods in state stores. Articles in the Soviet press have complained loudly about enterprises inflating the prices of new machinery products. Excess purchasing power also has probably led to an expansion of the underground economy, which results in resource diversions from the state sector and undermines attempts to spur state worker productivity through higher wages and salaries.

Gorbachev's policies are partly responsible for the deficit rise:

- State spending has risen rapidly as a result of large boosts in state investment and increases in total state subsidies on food and livestock products.
- Receipts from stiff sales taxes on alcoholic beverages are down substantially as a result of the regime's antialcohol program.
- Revenues from the large markups imposed on the retail prices of imported food and consumer goods have fallen sharply as a result of the cutback in these imports starting in 1986.
- Proceeds from enterprise profit taxes grew slowly last year because of production problems due to retooling, reforms, and quality control measures.

Figure 8
USSR: Estimated State Budget Deficit, 1981-89



* Projected.

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Annex C

Soviet Economic Reform: Signs of a Radical Economic Shift

Indicators of forward movement toward radical, market-oriented reform would include:

- Less emphasis on the fulfillment of 1986-90 Five-Year Plan targets and the announcement of realistic 1991-95 goals. The 1989 plan already has accepted targets for produced national income and industrial production that are lower than called for in the current five-year plan.
- Strong, united commitment by the leadership not only to the general concept of economic restructuring but also to individual elements of the reform program that are particularly controversial, such as essential price changes or even price reform.
- Willingness to carry through particularly painful adjustments such as bankruptcies that close down many enterprises and wage reforms that lead to wide differentials in pay.
- Evidence of a large expansion in the number of cooperatives (and employees of cooperatives) and the playing down of resentment by the general populace over egalitarian issues.
- Promulgation of major new agricultural reforms that reduce the powers of the state and collective farms.
- Greater consolidation of economic ministries, accompanied by cuts in staff and revision of their charters to steer them away from supervising the day-to-day activities of economic enterprises.
- Continued ability of reform economists to publish controversial articles that push the limits of reform.

Annex D

Update on Joint Ventures

Moscow has signed 41 joint-venture contracts with Western firms in 1988, bringing the total to 61 since legislation governing such contracts took effect in January 1987. Nevertheless, Soviet leaders are discouraged by the low level of investment and technology in most of these deals and are considering changing the program to encourage more Western participation. Such changes might spur additional contracts, but primarily from firms interested in small-scale projects.

Despite the surge in agreements, the Soviet leadership is far from satisfied with the progress of its joint-venture program. Service and consumer-related projects, rather than high-technology deals, still dominate the list of completed contracts.

Moscow's relative success in negotiating joint ventures is largely the result of greater Soviet flexibility, particularly in easing restrictions on the repatriation of profits, the biggest obstacle to concluding agreements. The original legislation allowed Western firms to earn hard currency profits only by exporting finished products of the joint enterprise. Moscow is now allowing an array of options, including countertrade agreements in which the Western partners export Soviet goods to earn hard currency. In one agreement, the Soviets reportedly will also allow a consortium of six US firms to repatriate profits by pooling their hard currency earnings.

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